United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

76-4162

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

FEDERAL BULK CARRIERS, INC.,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

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P/S

REPLY BRIEF FOR PETITIONER-APPELLANT

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February 25, 1977

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IN HIS BRIEF THE COMMISSIONER HAS AGREED THAT THE 1961 SALE OF TANKERS SECURITIES WAS A "CLOSED" TRANSACTION, AND IN SO DOING HAS WRITTEN THE STRONGEST AUTHORITY THUS FAR FOR REVERSING THE TAX COURT'S DECISION IN CASE.*

The Commissioner's tactics in this case are pure obfuscation and confusion. Initially, he misleads this Court into believing that the Record is so hopelessly confusing that it cannot be dealt with. (C. Br.** 12, 20). If there ever were any confusion in the Record -- which is not the case -- it was clarified by the parties in the Stipulation of Facts (R. 28 et seq.). There are no more than 100 pages of Exhibits in the Record presented to this Court, a rather meager amount given the magnitude of the transaction at issue. Accordingly, this Court should not let the Commissioner's assault on the nature of the Record preclude its fresh investigation.

The Commissioner also misleads this Court by urging the notion that it is critical to Federal Bulk's position that the form of the transaction which produced the losses in question be disregarded (C. Br. 11). All the facts were stipulated, and both sides are bound by

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* The definitions adopted in Federal Bulk's main brief are used in this reply brief.

** Commissioner's Brief.

the Stipulation. Nowhere in the Stipulation and nowhere in its brief, and indeed quite the contrary to the Commissioner's assertions, does Federal Bulk contend that the facts or the form of the transaction be treated in any way other than as they are presented on their face. It is inexplicable why the Commissioner would make such an assertion.

What the facts do show is that in 1961 Federal Bulk sold its Tankers securities (which were capital assets) in a transaction in which it reported a capital gain.* Federal Bulk continuously has asserted this sale was "closed"; the Commissioner in its brief has acquiesced in this conclusion. Simultaneously with the sale, Federal Bulk entered into a contract, the bottom line of which was that it had a direct economic interest in the operating expenses and revenues of the Monarch -- both on the up side if revenues less expenses exceeded stated levels, and on the down side if revenues less expenses fall below such levels. The contract covering the operations of the Monarch extended for 13 years after the sale of the Tankers securities. The fact the contract may have been entered into as a condition to the sale of the Tankers securities is irrelevant to this case.

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* The amount of the gain was $24,622.45, not some $400,000 as the Commissioner intimates on page 13 of his brief.

Contrary to the stipulated facts by which the Commissioner is bound, he blithely assumes that Federal Bulk had no chance for future profit under the contract, but only had a chance for future loss (C. Br. 27). The Tax Court made the same mistake, which Federal Bulk analyzed at length in the footnote beginning on page 21 of its main brief. By his silence, the Commisioner apparently agrees with Federal Bulk's analysis -- as he must since he is bound by the stipulation. The Commissioner's only response is that:

> "[W]hile the 1961 Indemnity Agreement did provide that Bessbulk would receive 35 percent of the amount of any excess of actual profits over projected profits, receipts were fixed, and it was unlikely that operating expenses would, in fact, be less than those already experienced. . . ." (C. Br. 27).

This gratuitous statement simply has no basis in the Record. As Federal Bulk demonstrated in its main brief, with each passing year operating expenses of the Monarch were reduced materially. If this trend had continued beyond 1965 (the year in which the Monarch was sold -- bringing Federal Bulk's contract with Maple Leaf to an end) profits above stated levels most likely would have been achieved in future years. A portion of these profits would have been credited and paid to Federal Bulk.

Federal Bulk took great pains in its main brief (pp. 19 et seq.) to establish that the sale of Tankers

securities in 1961 was a "closed" transaction. Its efforts apparently were unnecessary since the Commissioner has conceded the point:

> "[T]his case does not involve an open transaction and the Tax Court opinion does not make it one. An open transaction is one in which gain or loss cannot be calculated within a single accounting period because some part of the deferred consideration involved cannot be immediately valued. That problem did not exist in this case." C. Br. 15.
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> * * * *
>
> "Gain on the sale of the Tankers securities -- which was not a deferred payment sale -- was accurately calculated and reported as a capital gain in 1961. That transaction was closed in 1961. . . ." C. Br. 26.

Having made that concession, Federal Bulk wonders why the Commissioner continues to prosecute this case, and his basis therefor.

Once it is understood that the parties stipulated that Federal Bulk had a direct stake in the operating expenses and revenues of the Monarch for 13 years into the future -- both a realistic stake on the up side if the Monarch's revenues less expenses exceeded contract levels and a risk on the down side if revenues less expenses fell below such levels -- and it having been agreed by the parties that the sale of Tankers securities in 1961 was a "closed" transaction, the Commissioner's own rule of law declared in Revenue Ruling 58-402* governs the outcome of this case. That rule flatly states that in the case of a sale which is a closed transaction and provides for future payments between the parties:

"The results, for purposes of capital gains or

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* 1958-2 C.B. 15.

> ordinary income, are that if the sale or exchange remains an open transaction, because of unusual uncertainties with respect to valuations in rare and extraordinary cases, then the subsequent payments received under the contract will be subject to the appropriate capital gains provisions in the statute; but, if not, then the sale or exchange is a closed transaction, by reason of valuation of the contract or claim for indefinite amounts of income, and the subsequent payments in excess of basis received under the contract or claim constitute ordinary income. . . . Generally, when a taxpayer makes a gain from the sale or exchange of a claim or chose in action, if it is not a substitute for ordinary income, this is taxable as a capital gain; while if the gain results from the collection of the claim or chose in action, it is taxable as ordinary income." Id. at 17. [Citations omitted; emphasis supplied.]

While the Ruling specifically speaks to payments received as constituting ordinary income because the sale or exchange is "closed", conversely payments made must constitute ordinary deductions for the same reason.* Thus, under Revenue Ruling 58-402, payments made by Federal Bulk to Maple Leaf (using Bessbulk as the escrow fund -- C. Br. 18) are ordinary deductions for Federal income tax purposes.

Despite the Commissioner's own rule enunciated in Revenue Ruling 58-402 from which he cannot now escape, and despite his concession that the 1961 Tankers sale was "closed" when made, he nevertheless claims under Arrowsmith** that

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* An exception may apply if the payments made under the contract are capital expenses (e.g., wages paid to construct a capital improvement to property) or non-deductible personal expenses. Neither of these exceptions are applicable to the case at hand since payments made by Federal Bulk were directly related to the operating expenses and revenues of the Monarch shared under the contract.

** Arrowsmith v. Commissioner, 344 U.S. 6 (1952).

the losses incurred by Federal Bulk under its contract with Maple Leaf are capital losses because the 1961 Tankers sale resulted in a capital gain.

While the Arrowsmith doctrine has been applied in cases of transferee liability for corporate taxes (Arrowsmith itself), settlement of fraud claims (Kimbell v. United States, 490 F.2d 203 (5th Cir.), cert. denied, 419 U.S. 833 (1974)), damages paid to satisfy a warranty (John E. Turco, 52 T.C. 631 (1969); Rees Blow Pipe Mfg. Co., 41 T.C. 598 (1964), aff'd per curiam, 342 F.2d 990 (2d Cir. 1965); Estate of James M. Shannonhouse, 21 T.C. 422 (1953)), payments made under a guaranty (Duveen Bros. 17 T.C. 124 (1951), aff'd, 197 F.2d 118, (2d Cir.), cert. denied, 344 U.S. 884 (1952)), and penalties paid under Section 16(b) of the Securities Exchange Act of 1934 (e.g., Cummings v. Commissioner, 506 F.2d 449 (2d Cir. 1974), cert. denied, 421 U.S. 913 (1975)), it has never been applied in a case where the parties have agreed to share in an up side profit potential as well as a down side risk over a long period of time -- as the parties have stipulated to be the case here. One could hardly imagine the Commissioner arguing that Arrowsmith would apply if the profits of the Monarch exceeded contract levels and Federal Bulk received a share of those profits.

If, as the Commissioner urges, Arrowsmith were extended to apply to a situation in which post-sale operating revenues and expenses were shared between the seller and the buyer, ordinary profits could be converted into capital gains. For example, if taxpayer A sold a business to taxpayer B (a capital gain transaction) for a fixed consideration plus a share of the future profits of the business, less a share of the future losses of the business, under Revenue Ruling 58-402 the consideration reported by the seller would be the stated consideration plus the then value of the contract to share future profits and losses. Further under the Ruling, any subsequent amounts received or paid under the contract to share would be ordinary income or ordinary loss in the hands of the seller. If the Commissioner had his way, under Arrowsmith those subsequent payments would relate back to the sale and be treated as capital gains or capital losses. This result would fly in the face of Revenue Ruling 58-402 and the cases cited therein, and would convert the payments Revenue Ruling 58-402 demands to be treated as ordinary income into additional capital gains. Federal Bulk submits that the facts in this case are no different than the hypothetical example described above.

Federal Bulk points out once again that its view of this case is confirmed by the treatment of the same facts

by Canadian court.* While the Commissioner is correct in stating that the Canadian case is addressed specifically to the sale of Bessbulk and not the sale of Tankers (C. Br. 14), that is a distinction without a difference since the same contract to share revenues and expenses of the Monarch was considered by the Canadian court as is being considered here.

The Commissioner's only apparent thread of support for his position is the Duveen case, supra. But that support disappears as quickly as a mirage when it is realized that in Duveen the seller merely guaranteed that if the stock sold were redeemed, he would pay the buyers the difference between the selling price and the sum of the redemption price plus dividends paid during the intervening period. Unlike the stipulated facts in this case, the seller had no chance for a future up side profit. The Commissioner also dismisses the Hale** and Hess*** cases, which are in apparent conflict with Duveen, as having been decided before Arrowsmith. While this is true, the Commissioner has failed to point out that he acquiesced in the Hale decision in 1954, two years after Arrowsmith and Duveen. Further, he has allowed his earlier acquiescence in Hess to remain in effect to this day. The

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* Maple Leaf Mills Ltd. v. Minister of National Revenue, 72 Dom. Tax Cas. 6166 (1972).

** R.W. Hale, 32 B.T.A. 356 (1935), acq., 1954-2 C.B. 4, aff'd on other issue, 85 F.2d 819 (D.C. Cir. 1936).

*** Carl Hess, 7 T.C. 333, acq., 1946-2 C.B. 3.

Commissioner has announced that "acquiescence in a decision means acceptance by the [Internal Revenue] Service of the conclusion reached." 1954-2 C.B. 3.

The Section 16(b)* cases, notably Cummings, supra, upon which the Commissioner places great weight, have even less relevance than Duveen. In the first place, those cases involve no multilateral agreement between any parties to share profits and losses. The only transaction is to require the corporate officer or director to pay an amount almost in the nature of a penalty to the corporation with respect to which he is an "insider". The penalty is measured by the insider's "short-swing profits", a measure which may be far different from any gain recognized for Federal income tax purposes. Furthermore, the courts in the Section 16(b) cases have taken great pains to deal with the peculiar nature of Section 16(b), and to remove all incentive for short swing insider trading profit - including any "tax profit" which could be made by arbitraging a capital gain against an ordinary loss.

CONCLUSION

Thus far, the Commissioner's own brief is the strongest statement this Court has to reverse the decision

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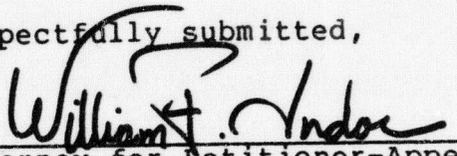
* Section 16(b) of the Securities Exchange Act of 1934.

of the Tax Court. The Commissioner contends, as Federal Bulk has contended all along, that its sale of Tankers securities in 1961 was a closed transaction. At the time of such sale, Federal Bulk entered into a contract under which it had a realistic chance to share in the excess operating profits of the Monarch for the next 13 years, and was likewise obligated to pay operating expenses of the Monarch in excess of certain levels over the same period of time. Therefore, if it can be said the parties stipulated that Federal Bulk "indemnified" Maple Leaf for minimum profit levels of the Monarch, it also must be said they stipulated that Federal Bulk was entitled to a share of profits of the Monarch in excess of those levels. Arrowsmith has never been applied to an indemnity (if that is what the downside half of the transaction in this case may be called) coupled with a chance to share in future profits. If this Court sustains the Tax Court and so extends Arrowsmith, it will frustrate the clear rule enunciated in Revenue Ruling 58-402 that a sale or exchange involving a contract providing for future payments between the parties is a "closed" transaction with all such future payments being considered ordinary income or ordinary loss transactions to the parties. Accordingly, this Court should reverse the decision of the Tax Court.

February 25, 1977

Respectfully submitted,



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CERTIFICATE OF SERVICE

It is hereby certified that the service of the Appellant's reply Brief has been made on counsel for Respondent-Appellee on this 25th day of February, 1977 by mailing 4 copies thereof in an envelope, with postage prepaid, properly addressed to him as follows:

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